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SUBJECT: LEADING MEXICAN ECONOMIST ON TAX AND FISCAL REFORM
ISSUES

Classified By: Economic Minister Counselor Vlad Sambaiew
for reasons 1.4 (b) and (d)

Introduction and Summary

¶1. (C) Econoff met with Dr. Fausto Hernandez, Economics Professor at Mexico,s Center for Economic Research and Teaching (CIDE), to discuss Mexico,s fiscal policy. Dr. Hernandez has done extensive research and published numerous studies on the subject. He discussed the origins of low tax collection rates in Mexico, reasons for high tax evasion, and the viability of passing fiscal reform during the next administration. Dr. Hernandez highlighted the consistently increasing informal economy in Mexico, and the fact that the incentives to evade taxes are greater than the costs of compliance. Despite the fact that fiscal reform seems to other economists as the most doable of needed Mexican structural reforms, Hernandez concluded that an overall fiscal reform would be unattainable and the feasibility of passing portions of a fiscal reform seem minimal. End Summary.

Mexico,s Tax Collection and Tax Evasion

¶2. (C) Dr. Hernandez explained that total tax collection in Mexico is only 9.8 percent of GDP. Mexico is the third lowest collector of taxes in Latin America, after Haiti and Guatemala. Under Mexico,s fiscal system, people are classified as &Moral People8 (those that own a business or corporation) and &Physical People8. Thirty-nine percent of moral people do not pay taxes, and 77 percent of physical people evade tax payment. Most of the proposals for a fiscal reform have recommended an increase in tax collection to only 12 percent of GDP, including Impuesto sobre el Valor Agregado (IVA), the equivalent to VAT.

¶3. (C) Despite the low tax collection rates, Hernandez said that, Mexico has very competitive tax rates of 20 to 22 percent of GDP, including IVA, which are similar to those of the U.S. The reason for Mexico,s competitive tax rates is that a provision under NAFTA stated that the tax rates of the countries participating in this agreement need to be similar to each other. At the same time, Hernandez explained that the two factors that contribute to Mexico,s meager personal

and corporate tax collection are evasion and avoidance.

14. (C) He noted that impunity in Mexico contributes to the country's high tax evasion. In Mexico, the probability of evasion detection is very low, and the likelihood of being penalized is even lower as the capacity to negotiate is always an alternative. In short, there is little incentive to pay taxes.

15. (C) Moreover, Hernandez said that the complexity of the fiscal law creates loopholes that facilitate tax avoidance while complicating the work of the Servicio de Administracion Tributaria (SAT), the equivalent to IRS. These loopholes are primarily created by many &Legal Privileges8 or more commonly known as exceptions. According to Hernandez, the GOM created these exceptions to meet the interests of certain sectors, such as agriculture or transportation. If these exceptions were reduced then tax collection would increase by 3 to 4 percent of GDP.

16. (C) Mexico's confidentiality laws, Hernandez explained, should cease to exist, as they impede tax collection and prevent the SAT, from performing uniform comparisons while hampering the transparency of the process. Furthermore, the SAT does not have the needed tools or ability to organize information collectively, only individually, hence precluding comparisons amongst sectors or groups, which could facilitate detection of disparities and outliers.

IVA Rates

7 (C) Hernandez stressed that, in order to reduce evasion; an integral reform with a flat IVA rate is needed. Currently

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there are four different IVA rates: zero rate, exempt, border rate, and general rate. Food and medicines fall under the zero rate category, which means that zero taxes are paid for the entire process, which is composed of five stages, of creating a specific food. This mainly benefits all the big and wealthy corporations that produce food or beverages such as Jumex. Books fall under the exempt category, because they are exempt to pay taxes for the fifth stage, and only pay taxes in the first four stages. The border rate was created to charge businesses along the border tax rates competitive to those charged on the other side of the border. However, according to Hernandez many businesses claim that their products are sold along the border, and thus avoid paying the higher general tax rate.

----- Feasibility of Passing a Flat Income Tax Rate Reform -----

18. (C) Hernandez explained that Calderon's proposal for simple flat income tax rate is good, yet it will be extremely difficult to obtain its approval as an amendment to the Mexican Constitution is allegedly needed to pass a flat income tax rate, he said. Article 31, fraction IV, of the Mexican Constitution stipulates that the Mexican tax system must be based on proportionality. Congruence should exist between the tax contribution or payment and the capacity of the taxpayer to make such a contribution, which is understood as the real potential to contribute to public expense. In other words, tax contribution is proportional. Those who earn more have a greater capacity to contribute more than those that earn less. Hernandez explained, a way to approve this reform without changing the constitution would be to exempt not only those who earn the equivalent to five minimum salaries, like Calderon proposes, but to establish a reduction base for everyone equivalent to five minimum salaries. This, analysts agree, would generate a sense of proportionality, as required in the Mexican constitution, benefiting primarily those that earn less.

¶9. (C) On the other hand, Hernandez explained that changing the IVA rate to a single rate, instead of four, does not require an amendment to the constitution. This would simplify matters, Hernandez added, as the IVA rate is highly politicized and there are many interest groups that oppose to any changes. Among the interest groups that oppose changes to the IVA rate are the business-owners, who according to Hernandez, are highly respected by many government officials, including Secretary of Hacienda (Treasury) Francisco Gil Diaz. Furthermore, Agustin Carstens, Deputy Managing Director of the IMF and possible candidate to become the next Secretary of Hacienda, also belongs to this interest group,

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Hernandez said. Therefore, according to Hernandez, any proposed changes to the IVA rate are unlikely to be approved.

¶10. (C) Mexico's fiscal problem, Hernandez noted, is the result of the lack of leadership and political willingness to make needed changes to increase tax collection and reduce evasion in Mexico. In addition, Hernandez concluded the long history of corruption has become a major factor that needs to be eradicated at all levels in order to make positive real change in the country.

Comment

¶11. (C) Dr. Hernandez, expertise and keenness on the subjects above provide useful perspectives on the feasibility of passing needed fiscal and tax reform in the near term, particularly given the fact that a constitutional amendment might be needed. It is, of course, too early to predict how a new GOM will proceed with structural and fiscal reforms. To give Washington agencies a better sense of the economic debates here, we will continue to provide views of leading Mexican economists on the challenges the new GOM will face.
End Comment.

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